Spotlight
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William C. Powers Discusses PIMCO's Cyclical Outlook and Global Strategy

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Mr. Powers joined the firm in 1991, previously having been associated with Salomon Brothers, and with Bear Stearns as senior managing director, specializing in mortgage-backed securities. Mr. Powers has twenty-four years of investment experience, and holds a bachelor's degree in economics from Princeton University and an MBA from Stanford Graduate School of Business.

Bill Powers is a senior member of PIMCO's Portfolio Management and Investment Strategy groups, and plays a key role in formulating the firm-wide viewpoints that shape every PIMCO portfolio. These views are guided by PIMCO's cyclical Economic Forums, which examine the outlook for the next six to 12 months, and the annual Secular Forum, which focuses on the three-to-five year outlook. Paul McCulley recently discussed the major conclusions from PIMCO's December Cyclical Forum, and in the interview below, Mr. Powers discusses the details of the firm's global outlook and investment strategy following the December Forum.

Q: What were PIMCO's key macroeconomic conclusions from the December Cyclical Forum?
Powers: The U.S. housing market is the core issue in the current cyclical environment. The housing market in the U.S. is the subject of a number of problems. First, supply and demand in the housing market are extremely imbalanced, with a much greater supply than demand for homes. Second, affordability remains very low.

Affordability is the result of three different inputs: the income of those who are looking to buy a home, the mortgage rates that dictate the cost of financing, and the price of the home. With the rise in home prices to extremely high levels in the U.S., mortgage lenders adjusted the financing side of the equation with exotic mortgages to keep homes affordable. As a result, at the peak in 2006, subprime and "Alt-A" mortgages grew to account for a combined 40 percent of the mortgage market.

The trend toward easier financing has now reversed. Credit conditions are tight, money is scarce and expensive, and both the primary and the secondary markets for non-agency mortgages – particularly for the Alt-A and subprime markets but also for prime jumbo loans – are extremely illiquid. Non-agency, non-conforming mortgage rates have not come down despite declines in Treasury rates since June of this year, creating significant problems in the housing market and posing a significant problem for policymakers, particularly in an election year.

Uncertainties with respect to subprime and other credit and structured exposures in financial institutions, and the damage to balance sheets and financial statements as a result of these exposures, are another significant issue for policymakers. Importantly, recent research has cast light on the possibility of $200 billion or more in bank losses, relating to $2 trillion in lost funding capacity because the banks are lending on a multiple of their balance sheet, often 10 to 1.

Hence, despite 100 basis points of ease by the Federal Reserve, financial conditions have not eased. Tighter financial conditions, overburdened debt, reduced wealth effects of falling home prices and higher costs of food and energy have combined to lower our forecast for U.S. GDP to 1% for the next 12 months, down from our September forecast of 1.5%.

We still do not expect that inflation will come down a great deal, largely due to sticky prices on food and energy, and a weak dollar. We see inflation of 1.9% in the core personal consumption expenditures index, which is just below the 2% level that Ben Bernanke used to assert as his comfort range for core inflation.

Q: PIMCO has forecast that the Fed will need to cut interest rates to 3% or lower in 2008, which is below the market's expectations. Why does PIMCO expect the Fed to cut rates so much?
Powers: We expect the Fed to cut rates to 3% or lower by the end of 2008, and we believe a Fed funds rate of 2.5% is a reasonable possibility. Our forecast is below the consensus forecast reflected in eurodollar futures and in Fed fund futures, primarily because our 1% GDP forecast is below consensus and has not been affirmed by the Fed or other forecasters.

If our 1% GDP forecast comes to pass, the Fed will grasp the gravity of the problem and will begin to ease with much greater haste to avoid a recession. While 1% growth is not quite a recession nationally, some regions and industries will necessarily experience growth at recessionary levels. Regional recessions, or recessions in industries such as housing or automobiles, will create a deadweight pull on the broader economy. Those recessionary regions and industries will lay off workers, cut costs and delay or postpone commitments. Eventually, the deadweight pull from recessionary regions and industries will push the overall economy to the brink of recession, quite possibly beyond the brink.

Q: How is PIMCO's slower growth forecast for the U.S. influencing the firm's global outlook? Does the firm still expect global growth to decouple from U.S. growth?
Powers: We have reduced our expectations for global growth over the cyclical timeframe, but we continue to expect decoupling of global growth from the U.S. The first decoupling is the developing world growing much faster than the developed world. We believe the developing world is going to continue to grow at levels of 8% to 10% despite modest growth of 1% to 2% in the developed world. The second decoupling is the decoupling of the rest of the developed world from the U.S. For the first time in a long time, we expect growth in Europe to exceed growth in the U.S. Over the next 12 months, we expect Europe to grow at 1.9%, the UK economy to grow at 1.8% and Japan's economy to grow at 1.2%.

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Q: What does PIMCO expect in terms of global inflation and how is this affecting the outlook for central bank rate cuts outside of the U.S.?

Powers: We expect a sticky inflation rate of 2.2% in Europe, despite a very strong euro. Normally, when a currency appreciates as rapidly as the euro has, there is some benefit in terms of lower inflation. But with higher food and energy costs, inflation in Europe remains sticky, which limits the likelihood of the European Central Bank easing policy until the U.S. falls into a recession. We expect similar rates of inflation in the UK, although concerns about the deterioration in the UK housing market and the debt-burdened UK consumer have already prompted the Bank of England's Monetary Policy Committee to ease.

In Japan, we expect inflation to remain slightly negative. Interest rates are already very low in Japan, with policy rates at 0.5%, and unlikely to come down further. Hence, the Bank of Japan will not be able to normalize rates, and rates in Japan are therefore unlikely to move very much.

Q: How are PIMCO's views on the global economy influencing the firm's investment strategy?

Powers: The bottom line is that the Fed needs mortgage rates to decline to address the problems in the housing market. Falling mortgage rates will not prevent sharp further declines in housing prices, but will limit the magnitude of housing price declines to perhaps a further 10% decline. This scenario favors large overweights in mortgage-backed securities.

In today's financial system, mortgage rates are not determined by policy makers or Treasury rates. Mortgage rates are determined by the spreads on mortgage-backed securities (MBS) relative to swaps and by swap spreads relative to Treasuries. Treasury rates have declined significantly more than mortgage rates and the Treasury curve has steepened. With the long end of the Treasury curve now close to the 2003 lows, we believe long Treasury rates are unlikely to fall much farther.

The decline in Treasury rates has had little effect on overall financial conditions, however, because swap spreads remain historically wide and the swap spread curve is still inverted. Two-year swap spreads are currently about 80 basis points over Treasuries while 10-year and longer swap spreads are about 65 basis points over Treasuries.

The Fed needs to attack high swap spreads and the inverted swap spread curve to normalize spread premiums on MBS and other high-quality income products. This is the goal of the Term Auction Facility (TAF) loan auction program that the Fed announced in December in concert with other central banks. As the Fed attacks the inversion in the swap curve and stubbornly high LIBOR term premiums, we would expect the swap spread curve to steepen to a more normal configuration, with two-year swaps spreads moving to 30-35 basis points over Treasuries versus the current 80 basis points, and with long-end swap spreads tightening slightly from their current level of 65 basis points. Thus, we believe there is additional steepening still to come in the swap curve. We also believe that Agency mortgage-backed securities, which are extremely high quality, offer considerable value at current spread levels.

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Q: Is PIMCO still bearish on the U.S. dollar?
Powers: As the Fed cuts rates, the U.S. dollar is becoming a low-yielding currency as opposed to a high yielding currency. Lower yields, combined with slower economic growth, will continue to make the dollar less attractive versus other currencies. Hence, the dollar is likely to continue its secular bear trend and we expect to continue underweighting the dollar in our portfolios and to continue to favor selective non-dollar investments. These include developing economy currencies such as Brazil, Mexico, Russia and Asian economy currencies like Korea and Singapore that are decoupling from the slower-growth developed world and are expected to enjoy continuing high rates of growth. We also expect the pound sterling to decline similarly with the dollar given that the Bank of England is in the process of cutting interest rates. Current overvalued levels of the euro lead to expectations of a lower euro as well. Appreciation in China's RMB, forecast at 8%, will take some of the recent pressure off European currencies. The dollar could very well outperform the British pound and the euro in 2008.

Q: Given the recent declines in the dollar, how much longer could the dollar bear trend last?
Powers: Despite the large drop in the dollar's value, we still believe there is more weakness to come relative to developing world currencies, though perhaps not versus most developed world currencies. The Australian dollar is a developed currency likely to outperform the U.S. dollar. As the Fed moves to rates that we think will surprise many market participants, the dollar will suffer further. When the Fed funds rate troughs at a rate of 2.5 percent, that will be the time to look for a correction to an oversold dollar, but not until then.

Q: In September, PIMCO began a slight shift toward higher exposure to corporate bonds and other forms of credit risk. Has the firm's view on credit changed at all following the December Forum?
Powers: We continue to find value in the very highest tiers of credit quality, particularly in sectors that have significantly underperformed. For example, we believe bank capital issues are tremendously attractive at current wide spread levels. If the Fed's target is to repair liquidity and bank balance sheet capacity, this easing cycle should certainly benefit banks. We remain selective in choosing which financial institutions to target with our investments, as 2008 will be a year of large differentiation in the performance of financial institutions.

Overall, we expect to remain slightly underweight in credit because we are concerned that credits with more exposure to cyclical economic weakness could lead to wider spreads. We also note that Fed easing in 2008 could very well sow the seeds for a credit event in 2009. During the Fed's last easing cycle, when the Fed funds rate fell to 1%, corporations were extremely levered and did not use the decline in interest rates to re-lever their balance sheets. That is one reason why corporations have been profitable and have been, as yet, generally unscathed by this market and liquidity debacle. However, if the Fed cuts rates to 2.5%, and if we continue to see corporations re-levering and borrowing aggressively in the corporate bond market, corporate credit could experience an episode of stress with perhaps significant further spread widening.

Because of these concerns, we remain very conservative and selective on credit and continue to favor very high quality assets, including within our high yield and emerging market exposures. This is the same philosophy that prompted us to avoid low quality asset-backed securities, non-agency mortgages and asset-backed commercial paper (ABCP).

Q: How much value does PIMCO see in the municipal bond market given concerns about the credit quality of companies that insure muni bonds?
Powers: Third-party insurance has created the ability to put a AAA rating on non-AAA municipal assets, which has opened the door for many buyers who might not otherwise be able to buy non-AAA muni bonds. However, some of these same bond insurers have also been providing credit enhancement to structured investment vehicles or collateralized debt obligations with subprime and other risky exposures. That has raised concerns about the insurers' ability to pay claims and prospects to secure financing, raising concerns about downgrade prospects on the ratings on some insured muni bonds.

So far, the insurers have been able to arrange financing. However, if the downgrade scenario unfolds and the insurers lose their AAA rating and are therefore unable to provide the AAA ratings on muni bonds they insure, investors may be forced to sell downgraded munis. However, while there could be dislocation in the muni market, munis are currently extremely cheap and generally very high quality. We think that cheapness puts munis right at the top of attractive assets for taxable investors, with the caveat that due diligence is extremely important in evaluating the quality of muni bonds.

Q: Thank you, Bill. We look forward to speaking with you again after PIMCO's next Cyclical Forum in March.

The Personal Consumption Expenditures (PCE) deflator is published by the Bureau of Economic Analysis as part of the GDP report. It measures inflation across the basket of goods purchased by households.

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